RETAIL AND WHOLESALE COMPETITION IN THE ILLINOIS ELECTRIC INDUSTRY: THIRD TRIENNIAL REPORT

ILLINOIS COMMERCE COMMISSION

May 2006

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

May 18, 2006

The Honorable Illinois General Assembly
State Capitol
Springfield, Illinois

Dear Members of the Illinois General Assembly:

Enclosed is the Illinois Commerce Commission's Report to the General Assembly entitled "Retail and Wholesale Competition in the Illinois Electric Industry: Third Triennial Report".

This triennial report is submitted in compliance with Section 16-120(a) of the Electric Service Customer Choice and Rate Relief Law of 1997, which requires the Commission to monitor and analyze the state of competition in Illinois electricity markets.

Sincerely,

Charles E. Box
Chairman

cc: Illinois State Library

527 East Capitol Avenue, Springfield, Illinois 62701 |TDD ("V/TTY") |217| 782-7434|

Executive Summary

The Commission hereby submits to the General Assembly the third triennial report, *Retail and Wholesale Competition in the Illinois Electric Industry*, as required by Sec. 16-120(a) of the Public Utilities Act ("Act"). This is the third report that the Commission has submitted pursuant to Sec. 16-120(a).[1]

According to Sec. 16-120(a), the Commission:

> … shall monitor and analyze patterns of entry and exit, applications for entry and exit, and any barriers to entry or participation that may exist, for services provided under this Article; shall analyze any impediments to the establishment of a fully competitive energy and power market in Illinois; and shall include its findings together with appropriate recommendations for legislative action in a report to the General Assembly.

The report examines the status of Illinois retail and wholesale power markets and barriers to entry to these markets. The report concludes that retail competition has gained a secure foothold only among the State's largest commercial and industrial customers. Significant competition among smaller-use customers, especially residential and small commercial customers, may take a very long time to develop.

The report shows that retail customers have realized significant benefits from a residential rate reduction and a rate freeze through the MTP. Rates for all customers have been frozen at 1997 levels, and residential rates for the State's two largest utilities, Commonwealth Edison ("ComEd") and Illinois Power (now AmerenIP), have been decreased by 20%. It is estimated that residential customers have saved approximately $4.5 billion as a result of the rate freeze and residential rate reductions.[2] Furthermore, thousands of non-residential customers have achieved significant savings by taking advantage of the opportunity to switch from bundled service to delivery services.

The expiration of the Mandatory Transition Period ("MTP") on January 1, 2007, will address some of the obstacles that have hindered the development of retail competition, but additional retail suppliers are needed if retail competition is to continue to grow in the areas and customer classes where competition has begun to take hold.

The report concludes that despite several positive developments that have occurred since the Commission's 2002 report, specific measures are still needed to further enhance the competitiveness of the wholesale market. Such policies as increasing the further development of a Joint and Common Market between RTOs, increased attention to the issue of transmission planning and expansion

---

[1] The Commission also submits annual reports concerning the development of competition under Sec. 16-120(b) of the Act.

[2] Data provided by electric utilities in response to data requests associated with the Commission's Section 16-130 Summary of Annual Reports filed by Electric Utilities Regarding the Transition to a Competitive Electric Industry.

and enhancement of the Commission's authority to access wholesale market data in the possession of the RTOs and Illinois generators are needed.

In the Commission's most recent Sec. 16-120(a) Competition report, which was submitted to the General Assembly in January 2003, the Commission looked forward with some concern to 2007 when the current rate freeze will terminate at the end of the MTP. The Commission noted that, after 2006, the Ameren Companies' and ComEd's sale or transfer of essentially all of their generating facilities would leave them dependent on wholesale market purchases for the power they will need to serve their bundled service customers. The Commission's concern derived from the lack of transparency in the wholesale market and a lack of independence between transmission owners and market participant -- both of which have the potential to prevent the benefits that a competitive wholesale market could provide from reaching consumers.

The first part of this report provides a more positive assessment of wholesale market developments since the Commission's January 2003 report, and identifies and discusses issues that the Commission believes must be addressed to further enhance the competitiveness of the wholesale market. The Federal Energy Regulatory Commission ("FERC") has been quite active in implementing policies that reflect its primary philosophy of relying on competition, rather than on traditional regulation, as the mechanism for producing just and reasonable rates. The majority of Illinois electric utilities are currently participating in Day 2 RTO spot energy markets that operate based on locational marginal pricing ("LMP") and regional security-constrained economic dispatch for the reliability and economic benefits that they bring. However, significant wholesale market impediments still need to be addressed if Illinois and the Midwest region are to see the full benefits that a competitive wholesale market can provide. In particular, the Commission is concerned with the seemingly lethargic development of a common market between PJM and the Midwest ISO, the evolving regional transmission planning and cost allocation process, the continued inability of the Commission to access the information necessary to effectively monitor wholesale market conditions and the slow development of a competitive market for ancillary services.

In the second part of the report, the Commission discusses the state of retail competition, which shows some encouraging progress after six years of customer choice. Switching statistics show that retail activity varies considerably throughout the State, and among customer classes. As of October 31, 2005, about 22,000 customers, or about 4.2% of all non-residential customers, were receiving delivery services. The delivery services customers switching are located in the four largest service areas of the State (AmerenIP, AmerenCIPS, AmerenCILCO and ComEd) only. However, the vast majority of delivery services customers are located within the ComEd service area. Retail suppliers have exhibited little or no interest in serving customers in the service areas of the State's four smallest electric utilities. Supplier switching by residential customers is nonexistent throughout the State. However, the Commission granted its first supplier certification to serve residential customers in 2005. The Commission considers this a positive step toward the development of competition for residential customers.

Approximately 70% of the above 1 MW customers in ComEd's service territory purchase electricity from alternative suppliers. These customers comprise approximately 54% of the demand attributable to all 1 MW and over customers in ComEd's service territory. Approximately 30% percent of the above 1 MW customers in AmerenIP's service territory purchase electricity from alternative suppliers. These customers comprise approximately 53% of the demand attributable to all 1 MW and over customers in AmerenIP's service territory. Less than 6% of under 1 MW customers have switched in ComEd's service territory, and less than 1% of 1 MW customers have switched in any other utility service territory.

Delivery services activity in the ComEd service territory is split between Retail Electric Supplier ("RES") supply and the Power Purchase Option ("PPO"), which is an unbundled discounted power and energy service, required, by statute, to be offered to non-residential customers by utilities that impose transition charges.[3] Approximately 18% of the entire retail load in Illinois is served by RES supply. PPO service should not be taken as a strong indicator of competitive activity since PPO customers are still purchasing their power supply from the incumbent utility.

Table 1 shows the supply selections chosen by non-residential customers as of October 31, 2005. The table indicates that only a small fraction of customers have taken advantage of the delivery services options created by Article XVI of the Act.

[3] See Sec. 16-110 of the Act.

Table 1: Nonresidential Delivery Services Customers (2005)[4]

Electric Utility	Eligible Customers	PPO Customers	RES Customers	Total Customers
AmerenCILCO	23,609	NA[5]	10	10
AmerenCIPS	56,138	NA	104	104
AmerenIP	68,027	454	167	621
ComEd	338,074	14,867	6,322	21,189
Interstate Power	2,532	NA	0	0
MidAmerican	10,304	NA	0	0
Mt. Carmel	938	NA	0	0
South Beloit	1,014	NA	0	0
Total	500,636	15,321	6,603	21,924

The expiration of the MTP will eliminate some of the circumstances that have discouraged retail market development. These circumstances have included the imposition of transition charges, the existence of the PPO, which serves as a supply option competing with options provided by alternative suppliers, frozen rates, and reciprocity requirements. After the end of the MTP, utilities will no longer impose transition charges, and the PPO may not be a favorable supply option for non-residential customers.

The expiration of transition charges at the end of the MTP and the lifting of the rate freeze, by themselves, may stimulate competition to a certain extent, at least in some areas. After 2006, customers in the AmerenIP and ComEd service territories will no longer be subject to transition charges, essentially an "exit fee," if they switch to an alternative supplier, and thus will be able to retain all of the savings that RESs can offer them. The expiration of the existing bundled retail rate freeze will provide electric utilities an opportunity to seek an increase in the rates charged to bundled service customers. Bundled rates could rise from present levels at the end of the rate freeze, depending on prices in the wholesale market at that time. RESs, which are currently finding it difficult to undercut the generation price implied in the bundled rate in several service areas and for

[4] Data is current as of October 2005. Data is taken from electric utility switching reports that are posted to the Commission's website at http://www.icc.illinois.gov/ec/switchstats.aspx.
[5] "NA" means the electric utility does not offer the service.

particular customer classes, may find it easier to compete against presumably higher utility bundled rates.

The end of the MTP, while likely beneficial to retail competition, will not necessarily result in a large number of additional customers switching to RESs. Switching may be limited in the foreseeable future to the State's largest customers, as is presently the situation. Even though utility bundled rates may rise in the future, utilities and RESs will both be buying essentially the same power and energy products from the same wholesale market. Utilities may be able to offer rates that are comparable to the rates that RESs will be able to charge to most customers, potentially leaving only perhaps a small number of customers to be served by RESs.

Recommendations

The Commission has concluded that the policies listed below would encourage customer and supplier interest in retail competition and enhance the competitiveness of the wholesale market, for the benefit of all Illinois electric customers.

First, the Commission recommends that the General Assembly take action to give the Commission the ability to monitor and promote the development of wholesale competition by obtaining information from the generating companies that operate in regional wholesale markets.

Second, the Commission recommends that the General Assembly take action to specifically provide for the construction of transmission facilities on the basis of the promotion of competition rather than strictly to meet reliability needs.

Third, the Commission recommends that the General Assembly provide the Commission with the authority to set rates for services required for the interconnection of "distributed generation" facilities with utility facilities.

Finally, the Commission recommends eliminating or modifying a provision in the Act that could discourage residential customers from switching to Retail Electric Suppliers.

In sum, the recommendations made by this report are as follows:

Recommendation 1. Enhance the Commission's Wholesale Market Monitoring Capability

The Commission should have the authority to obtain information from Illinois generating companies operating in RTO-managed markets from the RTOs themselves.

Recommendation 2. Allow New Transmission Investments on the Basis of the Promotion of Competition

In Sec. 16-101A(d) of the Act directs the ICC to "promote the development of an effectively competitive electricity market that operates efficiently and is equitable to all consumers." Facilitating improved transmission access is one way to promote the development of an effectively competitive electricity market. The proposed modifications to Sections 8-406(b) and 8-503 would more explicitly allow the objective of effectively competitive electricity markets to be taken into account when performing the analyses described in Sections 8-406(b) and 8-503.

Recommendation 3. Clarify Commission Authority to Set Non-discriminatory Stand-by Rates

Distributed generation will not be able to compete with traditional supply options if distributed generation owners are required to take supplemental power under discriminatory backup or stand-by tariffs. The Commission should be given explicit authority to set standby rates and other fees.

Recommendation 4. Eliminate or Modify the 24-month Minimum Enrollment Requirement in Sec. 16-103(d)

Elimination or modification of the minimum enrollment requirement would enable customers who return to bundled utility service to at least consider switching to a new alternative supplier.

Table of Contents

List of Tables

I. Introduction

A. History of the Illinois Electric Service Customer and Rate Relief Act of 1997

The Illinois Electric Service Customer Choice and Rate Relief Law "Customer Choice Act"), enacted in December of 1997, was landmark legislation that restructured the electric industry in the State of Illinois.

Illinois was among several states in the nation that changed its regulatory paradigm for electric utilities to allow a shift from traditional cost of service regulation to a greater reliance on market forces to discipline the price of power. The General Assembly embraced the restructuring model as a more efficient regime. The Customer Choice Act was designed to provide greater choice and additional value through products and services tailored to the individual retail customer while, at the same time, maintaining or enhancing system reliability. Inefficiently run utilities, power plant cost overruns, and high electric rates spurred the movement toward retail competition in Illinois.

The Customer Choice Act provided Illinois electric utilities with the opportunity to move away from the vertically integrated utility structure under which the utility provides a bundled service that includes generation, transmission and distribution service. The Customer Choice Act permitted Illinois electric utilities to divest their generation assets to affiliated and unaffiliated entities, mandated rate reductions for residential customers, froze all retail rates through January 1, 2007, and provided alternative suppliers with the opportunity to compete with other suppliers and the incumbent utility to sell power to retail customers. Electric choice for commercial and industrial customers was phased-in from October 1999 through October 2000. Residential customers were permitted to contract for electric supply from alternative suppliers beginning in May 2002, although no suppliers have ever served residential customers.

All major Illinois electric utilities divested their generation assets to affiliated and unaffiliated companies and no longer own generation. Illinois electric utilities are still required to act as the Provider of Last Resort ("POLR") and offer electric supply at a regulated rate to residential and the vast majority of commercial and industrial customers. However, the divestitures resulted in a fundamental change in how the major electric utilities acquire power and, consequently, how the Commission regulates the rates for electric supply.

Prior to the generation asset divestitures, utilities filed rate cases and cost-of-service/rate of return regulation was employed to calculate a bundled rate that recovered the cost of generation, transmission, and distribution expenditures. In the wake of the sales and transfers, the State's largest electric utilities no longer own the generation assets that supply power to serve retail customers but, rather, function as "wires-only" companies. These utilities must now purchase power in the wholesale market. Much of this power comes from generation assets that were previously owned by the utility but have been effectively removed from the Commission's jurisdiction through divestitures.

Transmission and distribution systems are still owned by the incumbent utility and are treated as natural monopoly services. The transmission rates are regulated by the Federal Energy Regulatory Commission and distribution rates are regulated by the Commission. In order to facilitate retail competition, the Customer Choice Act required Illinois electric utilities to unbundle electricity rates by calculating a separate rate for transmission and distribution service, although rates for these services for customers that remained on bundled service were not listed separately on customer bills. Delivery Service Tariffs ("DSTs") are designed to recover distribution and transmission costs from retail customers that purchase power from a Retail Electric Supplier ("RES") rather than the incumbent utility. When the rate freeze expires at the end of the MTP, all retail customers will be charged DST rates for transmission and distribution and will either purchase power and energy from the incumbent utility at a rate set through a Commission-approved auction or from a RES at an unregulated rate. The utility's rate for electric supply will be regulated by the Commission and be designed to recover the utility's cost of purchasing power in the wholesale market with no markup.

In effect, the Illinois legislature substituted electric restructuring for command and control regulation. The Customer Choice Act and ensuing generation asset divestiture removed the cost of generation from the Commission's regulatory purview. Retail electric customers in Illinois must now rely on competitive forces in the wholesale electricity market to discipline the price of electricity supply.

The General Assembly charged the ICC to "promote the development of an effectively competitive electricity market." The Illinois Commerce Commission has continued down the path set out by the General Assembly in 1997—a measured program toward fully competitive markets with strong regulatory oversight that will result in the greatest consumer benefits.

B. Impact of the Customer Choice Act

As previously mentioned, the Customer Choice Act has created a number of major changes to the Illinois electric utility industry. The Customer Choice Act granted customers the opportunity to switch from traditional bundled service by taking delivery services offered by electric utilities. At the same time, electric utilities were permitted to restructure their operations during the Mandatory Transition Period ("MTP") by selling or transferring their generating facilities, with very little Commission oversight. In this report, the Commission evaluates the impact that these changes might have on the future of the Illinois electric industry.

The impact of the Customer Choice Act on electric consumers has been manifested in two principal ways. First, retail customers have realized substantial benefits from a residential rate reduction and a rate freeze through the MTP. Rates for all customers were frozen at 1997 levels, and residential rates were significantly decreased for the State's two largest utilities, Commonwealth Edison ("ComEd") and Illinois Power (now AmerenIP). It is estimated that residential customers have saved approximately $4.5 billion as a result of the rate freeze and residential rate reductions.[6] Second, thousands of non-residential customers have achieved significant savings by taking advantage of the opportunity to switch from bundled service to delivery services. As of October 2005, from a non-residential population of about 500,000 customers, about 6,600 customers were purchasing power from a RES. Many new entities have been certified by the Commission to provide RES service to retail electric customers. An additional 15,300 customers were taking Power Purchase Option ("PPO") service. The PPO is a market-priced generation service offered by the electric utilities that impose transition charges that enables non-residential customers located in those service territories to obtain access to the competitive retail market. Currently, only AmerenIP and ComEd must offer the PPO.

The Commission notes that it has taken a number of proactive steps to encourage retail competition during the MTP. In particular, the Commission has enacted an administrative rule that addresses internal utility disincentives by preventing utilities from actively competing with RESs for customers;[7] it has approved refinements to the market value calculation methodologies used to set PPO rates and transition charges; it has approved tariffs that enable customers to "lock-in" transition charges for a multi-year period; it has narrowed the differences between utilities with respect to business practices and delivery service tariff provisions, and it declared service to three megawatt ("MW") and larger customers in ComEd's service territory to be competitive. Despite these actions, switching rates are generally low in many areas of the State, with the exception of the Chicago metropolitan area.

Switching activity, a measure of competition, has occurred only in the State's largest utility services areas. In the areas where switching has occurred, the largest-use customers have exhibited the highest switching rates. The switching rate drops as customer size decreases. The rate of switching to RES for non-residential customers under one MW is little more than 1% and reaches zero for residential customers.

The Customer Choice Act has also led to both the consolidation and the disaggregation of the Illinois electric industry during the MTP. Prior to the MTP, the State's largest utilities were vertically integrated and served their customers from their own generating plants. During the MTP, however, the utilities sold and transferred their generation plants, and engaged in mergers. The following restructuring activities occurred: ComEd transferred its nuclear fleet to an affiliate, Exelon Generation (an Exelon subsidiary), and sold its fossil-fueled plants to Midwest Generation (an Edison International subsidiary). Central

---

[6] Data provided by electric utilities in response to data requests associated with the Commission's Section 16-130 Summary of Annual Reports filed by Electric Utilities Regarding the Transition to a Competitive Electric Industry.
[7] 83 Illinois Administrative Code Part 452 (Standard of Conduct and Functional Separation).

Illinois Public Service Company ("CIPS") merged with Union Electric, a Missouri utility, creating the holding company Ameren. Illinois Power ("IP") sold its Clinton Nuclear Generating Station, and then was purchased by the energy company Dynegy, Inc. Ameren purchased Central Illinois Light Company ("CILCO"), and then purchased IP. The Illinois service territory of Union Electric Company, an Ameren entity, was incorporated into the CIPS service territory. Thus, there are now three Ameren utilities (AmerenCILCO, AmerenCIPS and AmerenIP). The generating plants formerly owned by CILCO and CIPS are now owned by an Ameren affiliate. The fossil-fueled generating plants formerly owned by IP are owned by Dynegy. The Clinton plant is owned by Exelon.

As a result of these changes, the State's four largest electric utilities are no longer vertically integrated, and the holding company Ameren operates the three formerly independent utilities CILCO, CIPS and IP (the "Ameren Companies"). As delivery-only companies, the Ameren Companies and ComEd, which together serve almost 98% of the State's retail customers, must purchase the power they need to serve their retail customers from the wholesale market. During the MTP, the utilities have primarily contracted with the new owners of their former generating for the power and energy that they need to serve their retail customers. These contracts will expire by 2007 and new power and energy contracts will be needed.[8]

The State's largest utilities' reliance on wholesale market purchases after 2006 combined with the simultaneous expiration of the rate freeze period will result in wholesale market forces dictating the price that retail customers will pay for power.[9] As the Commission noted in the 2002 Competition report, the State's ability to influence prices charged in the wholesale market is quite limited. While the Commission retains authority over the terms, conditions, and rates for bundled retail service and the distribution component of delivery services, the Commission has no authority over the price of wholesale electricity sold to utilities for resale to bundled customers, the price of transmission service in interstate commerce, or electricity sold directly to retail customers by alternative suppliers. These rates of wholesale activities are subject to the jurisdiction of FERC and, therefore, the Commission must rely on FERC to ensure that the prices for power sold to Illinois customers are reasonable.

C. Impediments to Wholesale Market Competition

In the 2002 Competition report, the Commission identified a number of problems with the structure of the wholesale market that were hindering development of competition. These primary problems included market power (the ability to affect market prices through strategic behavior) resulting from

[8] The issue of power procurement after 2007 was the primary subject of a Commission-sponsored workshop process known as the "Post-2006 Initiative". Material associated with that process, including the report the Commission submitted to the General Assembly, is available at http://www.icc.illinois.gov/ec/ecPost.aspx.
[9] Rates for MidAmerican Energy Company, which still owns generating facilities, may be an exception.

relatively high generation concentration in local generation markets; sole-supplier contracting, where a utility relies on a single supplier to provide its energy requirements rather than considering supply offers from competing suppliers; transmission infrastructure that was built for the needs of individual utilities rather than for wholesale competition; and the insufficient separation between the operating entities affiliated with holding companies. The Commission also noted that the wholesale market in 2002 could be characterized as lacking transparency and exhibited the potential for cyclical and spontaneous price volatility.

Since the 2002 report, several important events have occurred that should have a positive impact on the development of a competitive wholesale market. In particular, the majority of Illinois' utilities are participating in RTO Day-2 organized markets that operate LMP-based markets and security-constrained economic dispatch.[10] Similarly, FERC has issued orders or notices that address such issues as the standardization of procedures and agreements used for the interconnection of generators, a reexamination of the open access provisions of Order No. 888 and public utility tariffs to prevent undue discrimination, and preference in the provision of transmission services as well as the initial steps towards market coordination between PJM and the Midwest ISO.

Despite these steps, there are still impediments that need to be addressed if the Illinois and the Midwest region are to see the benefits that a competitive wholesale market can provide. Specifically, the Commission is concerned with the seemingly lethargic development of a common market between PJM and the Midwest ISO; the evolving regional transmission planning and cost allocation processes at the RTO level; the potential need for locational resource adequacy; the continued inability of the Commission to access the information necessary to effectively monitor wholesale market conditions; and, the slow development of a competitive market for ancillary services. Resolution of these issues will require action by FERC and/or the General Assembly.

The continued development of workably competitive wholesale markets could facilitate growth in retail competition. Moreover, the expiration of the MTP, the elimination of transition charges that utilities have been permitted to impose on retail electric suppliers and the diminution of the utility offered PPO should also positively facilitate retail competition,

The end of the MTP will not automatically change utility rates, but utilities will be permitted by 2007 to seek adjustments to existing rate levels. Presumably, retail rates will rise to more directly reflect wholesale market prices. Such increases could not only increase customer interest in seeking RES alternatives to utility service, but it could also eliminate any inherent price

---

[10] Ameren and Interstate Power are members of the Midwest ISO, which is an RTO that operates in 15 mid-western states and one Canadian province. Commonwealth Edison is a member of PJM Interconnection, which is a multi-state RTO operating in the Mid-Atlantic region. MidAmerican is not currently a member of an RTO.

advantage that utilities might have over RESs, who must pay market prices for the power they resell to customers.

It should be noted that the expiration of the rate freeze, while possibly enabling RESs to compete on an even basis with the services offered by utilities, will not necessarily guarantee that RESs will begin to inexorably chip away at the utilities' market share as soon as 2007 arrives. The Ameren utilities and ComEd will continue to be the State's major power buyers for the foreseeable future, and they will have the ability to use their huge buying power and their ability to aggregate the load of thousands of customers to obtain better prices from wholesale suppliers than RESs can generally achieve. If it turns out to be the case that RESs can purchase power on the wholesale market at a cost that is lower than the utility's average cost of service for only a small number of customers, retail competition may largely be restricted to large-use customers, as is presently the situation.

This does not mean, however, that retail competition should be reconsidered. Retail competition has provided benefits, primarily in the form of electric savings, but other benefits as well, such as the opportunity to receive new products and services or different types of pricing structures not offered by utilities, for a large amount of non-residential customer load and will continue to provide those benefits in the future even if utilities serve the majority of electric customers. The Commission remains hopeful that residential competition will begin to develop after the transition period ends.

Transition charges have been an impediment to competition during the MTP because customers' savings in the areas where the charges have been imposed have been limited to the extent of the size of the "mitigation factor." The mitigation factor will only reach 12% of a customer's bill in 2006.

The PPO, another impediment to robust retail competition, may not be available in its present form after 2007. While the PPO has enabled thousands of customers to enjoy savings compared to bundled rates, the existence of the PPO has tended to discourage customers that wish to obtain electric savings, but are reluctant to switch to an alternative supplier, from switching to RES supply.

In summary, as 2007 nears, with delivery services tariffs in place and the main obstacles to retail competition to be removed with the expiration of the MTP, retail competition is now well-established and may continue to grow. Future growth, however, may depend on the implementation of the policies that are discussed at the end of this report.

II. Assessment of the Wholesale Electric Market in the Midwest

A. FERC's Role in the Wholesale Market and Promoting Competition

The Federal Power Act gives FERC authority over all wholesale power sales by public utilities and all transmission of electricity by public utilities in interstate commerce. Since at least 1996, FERC has very actively advanced an agenda to introduce and promote competition in wholesale power markets as a substitute for traditional regulatory methods of ensuring just and reasonable rates.

In 1996, FERC issued Order 888, which required all FERC-jurisdictional electric utilities to provide open access to their transmission lines so that wholesale purchasers could access suppliers of electricity other than their local monopoly utility. While Order 888 was a major advancement to promoting competition, it was not enough to prevent electric utilities from operating their transmission systems in ways that provided unfair preferences to their own wholesale sales of electricity or the wholesale sales of electricity by their marketing or generating affiliates.

Consequently, in 1999, FERC issued Order 2000, which urged all transmission-owning electric utilities to either transfer operational control or ownership of their transmission facilities to an independent regional transmission organization so that all market participants, including the electric utility itself, could participate on an even competitive footing in the wholesale power markets. Unfortunately, compliance with Order 2000 was strictly voluntary for electric utilities, and as a result, RTO formation and development has been slower and less widespread than some had hoped. Order 2000 had other major weaknesses. In particular, it failed to draw a clear picture of a desired market structure, it failed to prescribe a detailed market design and it failed to require RTO operation of a transparent wholesale marketplace.

On July 31, 2002, FERC attempted to address many of Order 2000's deficiencies with a Standard Market Design Notice of Proposed Rulemaking ("SMD NOPR"). In particular, the SMD NOPR attempted to establish a standardized transmission service and an RTO-managed wholesale electric market design to provide a level playing field for all entities seeking to participate in wholesale electric markets, while recognizing certain regional variations. However, FERC's SMD policy initiative was not well-received in all regions of the country and generated strenuous political opposition, particularly in the southeastern and western states where traditional regulation or public power agencies remain strong. Consequently, on July 19, 2005, citing increased development of voluntary RTOs and ISOs and a stated intent to look into revisions to the Order No. 888 pro forma tariff in a separate proceeding, FERC concluded that the SMD NOPR was no longer necessary and terminated the docket.

Several notable efforts undertaken by the FERC in 2004 and 2005 include issuing a Notice of Inquiry seeking comment on whether reforms are needed to the pro forma open access transmission tariff found in Order No. 888 and to the tariffs of public utilities with the objective of preventing undue discrimination and preference in the provision of transmission services. FERC has also undertaken numerous other projects as a result of the Energy Policy Act of 2005 ("EPAct 2005"), the most significant energy legislation in twenty years. Among other things, the EPAct of 2005 requires FERC to implement standards for a regional reliability organization, participate in an electric energy market competition task force, implement the new provisions of the new Public Utility Holding Company Act and convene multi-state joint boards on the issue of security-constrained economic dispatch.

B. The Wholesale Market's Effect on the Illinois Retail Market

FERC's recent undertakings are a continuation of its primary philosophy of relying on competition, rather than traditional regulation, as the mechanism for producing just and reasonable rates. To a great extent, by adopting the 1997 Amendments, Illinois has placed its trust in a competitive wholesale market to discipline wholesale market prices and ensure just and reasonable retail rates in Illinois. This is especially true since the majority of the Illinois electric utilities either sold or transferred their generating plants to non-utility entities that are not under the jurisdiction of the Commission. Accordingly, responsibility for ensuring that electricity sales from those generators are just and reasonable has, for the most part, largely moved from the Commission's jurisdiction to FERC's jurisdiction and into the wholesale market.

While both of the major Illinois electric utilities now belong to RTOs that operate wholesale markets with locational marginal pricing and perform regional security-constrained economic dispatch, significant impediments still need to be addressed if Illinois and the Midwest region are to see the full benefits that a competitive wholesale market can provide. While there is a retail rate freeze currently in place in Illinois that provides retail customers some protection from the negative consequences of weak competition in the regional wholesale power market, that rate freeze is scheduled to expire on December 31, 2006. Moreover, Ameren and ComEd will procure power from the wholesale market through a reverse-style auction process that is designed to obtain power at the least cost available. Thus, the need to accelerate the development of a more efficient regional wholesale competitive power market is real.

III. Wholesale Market Components Needing Improvement or Monitoring

This section of the report identifies issues that the Commission believes need to be addressed to enhance the competitiveness of the wholesale market.

A. PJM/MISO Common Market Development

Since the General Assembly adopted the Customer Choice Act, the Commission has been a strong advocate of workably competitive wholesale markets and for transparency in the wholesale electricity market. A transparent wholesale market is a prerequisite that must be developed in order for Illinois' open access retail program to provide significant benefits to retail customers. Specifically, a transparent wholesale electricity market will allow a large number of buyers and sellers of electricity to easily find each other, compare prices and offers, and provide a way to get the product from the seller to the buyer. The benefits of a transparent market are directly correlated to the size of the market and the number and diversity of buyers and sellers transacting in the market. Much progress has been made in the last three years in the development and establishment of more transparent wholesale spot markets. Both PJM and MISO operate LMP-based day-ahead and real-time markets using bid-based regional security-constrained economic dispatch.

However, as noted earlier, one of Illinois' major electric utilities is within the PJM dispatch region and the other is within the MISO dispatch region. With ComEd operating in the PJM market and Ameren operating in the Midwest ISO market, an inter-RTO seam runs directly through Illinois. With each RTO operating separate markets and the associated RTO programs used to facilitate those markets, the problems that these issues present with the development of a transparent market for the Midwest is of considerable concern for the Commission regarding the creation of a large transparent market. Specifically, some of the long-term benefits that a single PJM/MISO market might include are increased grid reliability, reduced electricity spot-market prices, reduced costs of long-term energy contracts, increased fuel supply diversity among generators in the region, increased market liquidity, improved generator performance, reduced transaction costs and increased investment across the region from stable revenues. Indeed, the FERC registered concerns about split Midwest markets in its *Alliance Companies* order in 2002 conditionally approving the Illinois companies' RTO choices. Consequently, FERC directed the RTOs to develop a Joint Operating Agreement ("JOA") in the short term and development of a common market across the entire PJM/Midwest ISO region within several years.[11] Shortly thereafter, PJM and the Midwest ISO developed and filed a JOA for the purpose of coordinating market operations between the two RTOs.

[11] *Alliance Companies; et al*, 100 FERC ¶61,137 (July, 2002), hereafter, "July Order"

While the JOA has resulted in significant operational efficiencies through improved coordination between the two separate RTO markets, there are additional long-term benefits that could be gleaned from a single market that spans the Midwest ISO/PJM region. Unfortunately, the RTOs have not been actively moving forward to develop the common market. Rather, the Midwest ISO and PJM recently filed a status report recommending that FERC reconsider its single region-wide market directive and accept the continued coordinated separate markets that the RTOs are currently operating under the JOA. The Commission disapproves of the RTOs' proposal merely to continue coordinated separate markets and not seek to develop a single common market, as the magnitude of the benefits that a single PJM/MISO market could provide are significant.

Indeed, in 2002, PJM and the Midwest ISO commissioned a study of the benefits of a single market across the collective Midwest ISO-PJM-Southwest Power Pool (SPP) region. Among other things, the report concluded that "it is reasonable to say that the development of the single MISO-PJM–SPP market will save consumers from several billions of dollars to several tens of billions of dollars over the next ten years."[12] A second major conclusion of the study was that "the establishment of a joint and common Midwest ISO-PJM-SPP market will provide financial power markets with sufficient depth and liquidity to enable effective forward contracting and other forms of risk management by both buyers and sellers."[13] Even with SPP removed from the analysis, a large transparent wholesale market for the Midwest combining the MISO and PJM regions would provide significant benefits for Illinois electric consumers. Given the RTO choices of the Illinois utilities and the geographic configuration of the MISO and PJM regions, development of a PJM/MISO common market could be of significant help in facilitating the goals of Illinois' 1997 restructuring initiative.

B. Transmission Expansion

One of the key elements of a competitive wholesale market is the ability of the transmission system to efficiently and cost-effectively move power to where it is needed throughout the region. An efficient transmission system facilitates competition by improving the ability of market participants to access markets and/or cheaper generation sources. Simply put, an inadequate transmission system prevents efficient low-cost power supplies from reaching markets, thereby allowing generators that can reach those markets to charge relatively higher prices than would otherwise be the case. Ultimately, an inefficient transmission system contributes directly to the volatility of energy prices and higher ultimate prices that both wholesale and retail customers pay for power.

In the past, transmission management, planning and expansion in the Midwest was a slow, disjointed process that was potentially marred by conflicts of interest between a utility and its affiliates. Typically, each transmission owner

[12] ESAI study at 4.
[13] ESAI study at 4.

would focus on its own portion of the grid and weigh the effects any changes will have on its own and its affiliates' generation supply profitability, rather than examining the transmission system as a regional grid and working to find solutions to regional transmission congestion and reliability problems. As with many of the other problems in the wholesale power market, FERC initiated reforms that attempted to help improve the efficiency of transmission grid expansion. In particular, the formation of RTOs helped to alleviate many of these problems by examining the transmission system as a regional grid and working to find regional solutions to transmission limitations. Transmission planning on the RTO level has helped to address some of the transmission access problems in the Midwest. However, the RTO transmission expansion process that is currently in place is still largely a "rolling-up" of the transmission plans of the transmission owners that are RTO members. While the RTOs have some authority to modify the transmission expansion plan, that authority is limited. Furthermore, the current expansion approach is significantly less efficient than a more heavily-weighted "top-down" approach where the RTO would independently determine what regional transmission expansion projects are necessary. The result is that, to date, very little transmission expansion has occurred as a direct result of RTO planning.

Furthermore, setting aside the issues regarding the process used to determine which expansion projects are needed, the issue of determining who is responsible for paying for expansion projects that provide regional benefits is a matter that still needs to be resolved. In particular, the problem lies in the fact that beneficiaries of transmission projects can be – and often are – located in areas that are outside of the location where the expansion project is sited. As one would expect, this issue of allocating the costs of a regional transmission project is particularly thorny. To date, there has been significant effort by the FERC, the RTOs and their stakeholders to develop allocation processes that acknowledge this concern and attempt to address it, but the problem is still not solved.

On top of the transmission planning and transmission cost allocation problems, the incentives of some parties to actually see a project through to completion are weak. For example, electric utility companies or electric holding companies that are integrated in both generation and transmission may not perceive it to be in their best corporate interests to build transmission that would enable competitors to enter their protected markets and compete with their generators. The role of RTOs in the transmission planning process has led to some diminution of this concern for inter-affiliate preference, but the problem has not been completely resolved and the transmission utility's preferential incentives have not been removed.

Most of these concerns apply as well to transmission expansion for new generator interconnection. In the past, the process for interconnection of new generators to the existing transmission system created real barriers to entry. Given that many of the transmission providers had generation affiliates that would compete directly with any new generator seeking interconnection, the incentive existed for transmission providers to engage in practices that were less than fair when addressing issues associated with generator interconnection. Accordingly, in 2003-2005, FERC issued numerous orders that have focused on standardizing the interconnection procedures and agreements used for the interconnection of generators above 20 megawatts, less than 20 megawatts, and those using wind or alternative technologies. Since then, FERC and numerous stakeholders have been working towards developing principles regarding the allocation of costs associated with generator interconnection-related network upgrades that recognize the issues of cost-causation and beneficiaries of the upgrades.

Despite the progress that has been made in developing RTO processes and procedures that can accommodate or facilitate needed regional transmission expansion, unresolved issues remain in the areas of: RTO transmission planning capabilities and authorities, transmission cost allocation, facilitating transmission expansion to address economic congestion issues, and state/federal transmission siting authority friction. Transmission planning and expansion remains an issue still needing significant improvement to enable competitive wholesale markets to achieve their potential.

While the Commission's direct authority to improve conditions for regional transmission grid expansion is limited, the Commission does have an important role, for example, in facility certification and siting. Article VIII of the Public Utilities Act addresses the Commission's authority concerning transmission facility certification and siting. In subsequently adopting Article XVI of the Act in 1997, the General Assembly directed the Commission to promote competitive electric markets as the means to advance the public interest. However, Article VIII was not modified to explicitly authorize the Commission to grant certificates and site transmission facilities for that purpose. In order to improve clarity, the facility siting and certification provisions of Article VIII should be revised to reflect the pro-competition directive of Article XVI. This issue is addressed in Section VI below, Recommendation 2.

C. Locational Resource Adequacy

Historically, the transmission system was constructed and maintained primarily to deliver local generation supplies to local loads and was interconnected to neighboring systems to access lower cost reserves. With open access and market regionalization, the transmission grid's role in facilitating competitive markets became critical. However, it would probably not be practical or cost effective to construct a transmission grid that would permit all load in the PJM/MISO region to be economically and reliably served regardless of where generation is geographically located. Building that much transmission would be very expensive. Accordingly, issues associated with the relationship between geographic or electrical locations of loads and new generating capability will continue to be important. The RTOs' use of locational marginal pricing as a means of congestion management in spot markets contributes to market resolution of those issues. However, some market participants and some RTOs argue that, because of "frictions" built into the design of the RTO-managed regional energy spot markets, sufficient locationally-specific generation will not always be built in the future to ensure locational resource adequacy. Some of the "frictions" that are cited by mandatory capacity market advocates include over-mitigation (offer caps) of supplier offers in RTO spot markets, and unidentified disincentives for voluntary forward energy contracting by market participants. To address these concerns, RTOs have studied or proposed various types of mandatory capacity markets as a means to ensure resource adequacy.

While locational resource adequacy does not appear to be an immediate problem for the portion of the PJM/MISO grid most relevant for Illinois, this matter merits ongoing review. In particular, the RTOs' proposed solutions may impact Illinois even if Illinois does not suffer from resource adequacy problems.

D. Ancillary Services Market Development

Beyond the basics of energy, generating capacity, and power delivery, generation-related transmission ancillary services are necessary for the operation of the electric grid.[14] Some of these ancillary services are required during normal operations to maintain the necessary balance between generation and load in real time as well as maintain voltages within the required ranges and others provide system redundancies to prevent minor operating issues from spiraling into serious problems.

Some ancillary services, such as real-time regulation and operating reserves, are conducive to competitive market-type provision. Indeed, these ancillary services are provided largely by the same generators that are providing the energy that is bought and sold within the RTO energy markets. Market development would facilitate more efficient procurement of these ancillary services. PJM has made some progress in these areas, but MISO is just now at the initial stages of designing markets for these products.

Retail customers in Illinois could see significant benefits from a properly designed competitive market for ancillary services and the Commission should encourage continued RTO work in these areas.

E. Market Power Monitoring

Wholesale market transactions are direct inputs into retail transactions, or, put another way, retail prices directly reflect the costs of power purchased in the wholesale market. As mentioned previously, the 1997 Amendments have put the Commission in the position of largely relying on wholesale markets as a means to discipline prices charged in retail markets. Accordingly, if the price of power in the wholesale market is subject to manipulation, the potential for serious harm to

[14] Ancillary Services are required to deliver electricity to end-users at stable frequencies and voltages, such as frequency regulation, spinning reserves, non-spinning reserves, and reactive supply/voltage control.

Illinois ratepayers is real. Therefore, it is critical that the Commission be able to act swiftly to identify any abuse of market power and anticompetitive behavior of market participants to prevent serious harm from befalling retail ratepayers.

Sec. 16-101A (d) Act directs the Commission "act to promote the development of an effectively competitive electricity market that operates efficiently and is equitable to all consumers." The ability of the Commission to fully satisfy its statutory obligation regarding monitoring of the competitiveness of wholesale electric markets and protecting retail customers from the exercise of market power hinges on access to market participant transaction data and information in the possession of the RTOs and their Market Monitors. Without access to adequate information, it will be difficult, if not impossible, for the Commission to determine if aberrant prices in the wholesale market are the result of genuine transmission system/supply scarcity issues or price manipulation on the part of market participants.

Unlike commissions in traditionally regulated states that can command generation information from jurisdictional integrated utilities, this Commission lacks sufficient statutory authority to obtain generation data from unregulated generation companies operating previously utility-owned generators. Similarly, the Commission lacks authority to obtain data from unaffiliated generating companies or market participants located in Illinois or in other states. Therefore, the Commission has had to rely on publicly available data to conduct its market monitoring mandate. While the quality of this data has improved considerably, it is not of the same quality or thoroughness as RTO data. Accordingly, the Commission and numerous other states in the PJM/MISO region have spent nearly two years seeking FERC authorization that grants state commissions access to data in the possession of both PJM and the Midwest ISO.

The Commission Staff participated in the PJM regional stakeholder process that was begun in the fall of 2003. In June 2004 the FERC issued an Order that accepted relatively few of the Commission's recommendations. In short, FERC's Order approved PJM's proposal that conditioned a State Commission's receipt of confidential information on its ability to sign a non-disclosure agreement ("NDA"). While the NDA approach is not problematic in and of itself, the particular terms of the NDA proposed by PJM and approved by FERC make it difficult for most states in the PJM footprint to meet its terms.

Specifically, Section 18.17.4(a)(ii) of the PJM Operating Agreement requires, among other things, that a state commission provide an iron-clad guarantee that it can protect the confidential information in its possession and not release it to any other entity.

> The Authorized Commission employing or retaining the Authorized Person has provided the Office of the Interconnection with . . . (b) either an order of such Authorized Commission or a certification from counsel to such Authorized Commission, confirming that the Authorized Commission (i) <u>has statutory authority to protect the</u>

confidentiality of any confidential information received from public release or disclosure to any entity . . . (Emphasis added)

Commission Counsel has determined that the Illinois Freedom of Information Act (FOIA) supersedes a confidentiality agreement like that in the PJM NDA and the Commission will not be able to rely on the NDA to shield information from disclosure. Commission Counsel has also determined that the only thing that would allow the Commission to make the iron-clad guarantee that PJM's NDA requires would be a State statute expressly exempting market participants' materials from disclosure under the FOIA. Specifically Section 7(1)(a) of the FOIA exempts "information specifically prohibited from disclosure by federal or State law or rules and regulations adopted under federal or State law."

Accordingly, access to sufficient market data is a problem that needs to be addressed so that the Commission can effectively monitor conditions in the electricity markets as envisioned by the 1997 Amendments. This issue is addressed below in Section VI, Recommendation 1.

IV. Assessment of Retail Electric Markets in Illinois

This section discusses supplier and customer activity in the retail electric market. The first non-residential customers became eligible for choice in October 1999, and all non-residential customers were eligible by January 2001. Residential customers became eligible in May 2002.

A. Delivery Services Tariffs and Transition Charges

Each Illinois utility filed and received approval from the Commission for cost-based delivery services tariffs that enable non-residential retail customers to purchase power and energy from alternative suppliers. According to Sec. 16-108 of the Act, the delivery services tariffs approved by the Commission must be non-discriminatory – i.e., the tariffs must be made available to all customers on the same terms and conditions without regard to a customer's choice of supplier.

Sec. 16-108 permits utilities to impose transition charges on customers that choose to purchase power from alternative suppliers. Initially, CIPS, ComEd, Illinois Power and Union Electric imposed transition charges. However, CIPS and Union Electric suspended their collection of transition charges in 2002, and currently only ComEd and AmerenIP impose these charges.

B. Patterns of Entry: Retail Electric Suppliers

Sec. 16-120(a) directs the Commission to report on patterns of entry to Illinois markets. This section describes the retail activities of the entities that are authorized to participate in customer choice by selling power and energy to customers. There are two types of such entities: (1) Retail suppliers that have obtained Alternative Retail Electric Supplier ("ARES") certification from the

Commission; and (2) Illinois electric utilities, which, under Sec. 16-116 of the Act, are permitted to sell power and energy to customers outside their service areas. Collectively, suppliers serving retail electric customers under delivery services tariffs are termed "Retail Electric Suppliers" or "RESs."

1. Applications from Alternative Retail Electric Suppliers

Sec. 16-115 of the Act establishes the standards that a prospective ARES applicant must meet to obtain certification from the Commission. Among other things, this section of the Act requires a successful applicant to demonstrate to the Commission its "technical, financial and managerial resources and abilities" to provide service to retail customers. The Commission adopted rules at 83 Ill. Adm. Code 451 ("Part 451") to implement Sec. 16-115 and guide the ARES certification process.[15]

Utility affiliates who wish to sell power and energy must also receive certified status as an ARES. Utilities and their affiliates are subject to 83 Ill. Adm. Code 450, the rule governing utility/affiliate relations that the Commission adopted pursuant to Sec. 16-121 of the Act.

A prospective ARES' application must identify each area in which it intends to serve. Most applicants have sought certification in each of the State's largest service areas. Also, each application must specify the customer groups that the ARES intends to serve. Based on Part 451, applicants may obtain certification to serve any of the following customer groups: (1) all non-residential customers; (2) all non-residential customers with greater than 15,000 kWh annual usage; (3) only customers with demand greater than one MW; or, (4) residential customers. Most ARES have applied to serve all non-residential customers, although a few applicants have sought certification to serve one MW or greater customers only. One received certification to serve residential customers.

Prospective ARES have submitted about 30 certification applications since 1999. Almost all of these applications have been approved. Three applicants have been rejected because of their inability to demonstrate compliance with the "reciprocity" provisions of Part 451 (one of the rejected applicants later received certification). Several applicants have withdrawn their applications during the certification proceedings following a preliminary recommendation that their applications should be denied. Several ARES have voluntarily surrendered their certificates and ceased operating in Illinois.

2. Electric Utilities Serving Outside Their Service Areas

When the retail market opened in 1999, AmerenCIPS, AmerenCILCO, AmerenIP, MidAmerican Energy Company and South Beloit Water, Gas and Electric Company expressed an interest in serving retail customers outside their home service areas. Currently, MidAmerican is the only electric utility that markets outside its service area.

[15] Docket Nos. 98-0544 and 98-0649.

Regulations adopted by the Commission governing supplier behavior are designed to ensure that the regulations apply equally to all RESs (except to the extent that certain statutory provisions may apply to only one or the other supplier category).

3. Active Retail Electric Suppliers

As of November 2005, a total of 19 alternative suppliers were qualified to sell power and energy to retail customers. Ten suppliers were active in 2005 (that is, actually made electricity sales). Thus, almost one-half of all RESs hold certificates but are not currently making sales. Four eligible suppliers are either electric utilities or affiliates of electric or natural gas utilities. A list of RESs can be found on the ICC website at http://www.icc.illinois.gov/ec/docs/arescertlist.doc.

Most suppliers concentrate their marketing efforts in the ComEd service territory, where eight suppliers sold power and energy in 2005. A total of six suppliers sold power and energy to retail customers of the three Ameren utilities in 2005. The Commission notes that in 2005 it granted its first certificate to a RES applicant to provide alternative electric supply to residential customers, an encouraging sign of possible development of retail competition among residential customers.

Table 2: Number of Active Retail Electric Suppliers per Utility Service Territory (2000- 2005)[16]

Utility Service Area / Year	2000	2001	2002	2003	2004	2005
AmerenCILCO	0	0	0	1	1	1
AmerenCIPS	3	2	4	5	5	4
AmerenIP	4	3	4	3	3	4
ComEd	8	7	8	8	8	9
MidAmerican	1	1	0	0	0	0
All Others	0	0	0	0	0	0

[16] Data is current as of June 30, 2005.

C. Alternative Supply Options

The Act recognizes several distinct customer power and energy supply options. Customers may opt for purchases from RESs or continue taking bundled service from the incumbent electric utility under the currently frozen rates.[17] Sec. 16-110 of the Act requires utilities that impose transition charges to offer PPO service. The PPO offers customers the option of unbundled service from the utility at market-based power and energy prices. Customer savings are a function of the mitigation factor, the customer's load factor and any administrative fee imposed by the utility that is approved by the Commission. In 2005, the mitigation factor for non-residential customers is the greater of 0.6 cents per kWh or 11% of the customer's base or contract rate. In 2006 the mitigation factor will increase to the greater of 0.9 cents per kWh or 12% of the customer's base or contract rate.[18]

The Act allows electric utilities to offer power and energy contracts to any of their customers without Commission approval.[19] These discretionary contracts offered by utilities are essentially bundled service contracts that are discounts from the standard bundled rate. However, the Commission's adoption of 83 Ill Adm. Code Part 452 ("Part 452") in February 2002 severely restricted the ability of utilities to attempt to retain customers by offering discounted rates. The majority of the discounted rate contracts have expired and will not be renewed.

Sec. 16-106 permits electric utilities to offer experimental programs for the "provision or billing of services on a consolidated or aggregated basis, as well as other experimental programs." The design of the experimental programs, choice of participants and participation inducements are at the discretion of the utility offering the program. AmerenCIPS, AmerenUE, ComEd, and AmerenIP have offered load curtailment programs under Sec. 16-106, generally to large-volume customers.[20] ComEd has implemented several other experimental programs to well-defined customer groups. However, following the adoption of Part 452, the utilities discontinued almost of all their experimental programs. The only three programs that were operational in 2005 have been closed to new customers for some time.

Sec. 16-107 of the Act requires electric utilities to offer to non-residential customers real time pricing service. Real-time pricing service, as provided in the Act, is bundled service in which prices vary on an hourly basis throughout the day. The customers that have the greatest potential to benefit from a "real-time" pricing tariff are the customers with the capability to control electric consumption and take advantage of off-peak electric prices. The statutorily required real-time pricing tariffs became effective October 1, 1998.

---

[17] Customers may also generate power for their own use on their premises.
[18] See definition of "transition charge" in Sec. 16-102.
[19] See Sec. 16-116.
[20] The Commission is required by Sec. 16-106 of the Act to describe each experimental program initiated by an electric utility under Sec. 16-106 in an annual report to the General Assembly.

D. Customer Supply Selections

Table 3 below shows that about 22,000 customers were receiving delivery services as of October 31, 2005. Switching to delivery services has occurred in the State's four largest service areas only. As the table shows, the total number of delivery services customers has actually declined since 2002.

Among individual utilities, ComEd's customers have been the most active consumers of the alternative supply options created by the Act. As of October 2005, a total of 6,322 ComEd non-residential customers were taking service from a RES, and an additional 14,867 customers were taking supply service from ComEd under the PPO. The number of ComEd delivery services customers in 2005 is about the same as the number of delivery services customers in 2002. However, the relative proportion of PPO and RES customers changed significantly between 2002 and 2005. In 2002, there were about 1.5 RES customers for each PPO customer. By 2005, there were about 2.3 PPO customers for each RES customer.

As with ComEd, the total number of AmerenIP delivery services customers changed very little between 2002 and 2005. However, unlike ComEd, AmerenIP customers moved in significant numbers from PPO service to RES service. In 2002, about 90% of AmerenIP delivery services customers were taking service under the PPO. However, by 2005 the percentage of PPO customers had dropped to about 70%.

The number of delivery services customers dropped sharply in the AmerenCIPS service area between 2002 and 2005. In 2002, when AmerenCIPS offered the PPO to nonresidential customers, 544 customers were taking that service. Although AmerenCIPS suspended its collection of transition charges, the number of RES customers fell from 193 customers in 2002 to 104 in October 2005. There were no delivery services customers in the AmerenCILCO service area in 2002, but, by October 2005, there were 10 customers taking service from RESs.

No customer of any other electric utility was receiving delivery services.

Table 3: Comparison of the Number of Delivery Services Customers in 2002 and 2005[21]

Supply Option		PPO		RES		Total	
Utility	Year	2002	2005	2002	2005	2002	2005
AmerenCILCO		NA	NA[22]	0	10	0	10
AmerenCIPS		544	NA	193	104	737	104
AmerenIP		976	454	16	167	992	621
ComEd		8,797	14,867	12,770	6,322	21,567	21,189
All Others		NA	NA	0	0	0	0
Total		10,317	15,321	12,979	6,603	23,296	21,924

E. Customer Switching Statistics

Table 4 provides additional information about non-residential customers' selection of delivery services. The table shows the percentage of customers and percentage of customer load that is taking delivery services. The data is further disaggregated to show these categories for customers with a peak demand under one MW and also for customers with a demand that exceeds one MW.

The tables show that customer interest in delivery services is related to the size of the customer load. Smaller-use customers – that is, customers with a demand under one MW -- have exhibited only a minimal interest in switching to alternative supply options. Only in the ComEd service area, where about 6% of customers have switched, has customer choice taken hold to any appreciable degree among customers under one MW. It is clear from the table that it is the largest customers in the under one MW category that comprise the majority of switched customers. In the ComEd service area, the percentage of customer load that switched to delivery services is about six times higher than the percentage of customers that have switched. In the other service areas in which customers have switched, the ratio is even higher.

In contrast to the lack of interest shown by smaller-use customers in alternative supply options, there is clearly a great deal of enthusiasm for customer choice among larger-use customers, at least in the State's two largest

[21] The source for the 2002 data is the Commission's 2002 Sec. 16-120(a) report; the data source for 2005 is the October monthly switching report that is available on the Commission's website. The 2005 data excludes "Interim Supply Service," "Other," and "Governmental" customers.
[22] "NA" means the electric utility does not offer the service.

two service areas. In the ComEd service area, about 70% of larger-use customers have switched to an alternative supply option, and about 30% of AmerenIP customers in that demand category have switched.

Table 4: Percentage of Non-Residential Customers and Customer Load Receiving Delivery Services, by Demand Class (2005)[23]

	Percentage of Customers Receiving Delivery Services		Percentage of Usage Receiving Delivery Services	
Utility / Demand Class	Under 1 MW	Above 1 MW	Under 1 MW	Above 1 MW
AmerenCILCO	0.03	2.2	0.04	30.4
AmerenCIPS	0.2	5.4	3.0	2.8
AmerenIP	0.8	29.5	6.4	53.2
ComEd	6.0	70.3	36.1	54.1
All Others	0.0	0.0	0.0	0.0

F. Barriers to Competition in Retail Electric Markets

Potential barriers to competition in the retail market during the Mandatory Transition Period have included the existence of transition charges and PPO service as an alternative supply option, the reciprocity provisions that restrict the pool of potentially qualified suppliers, a lack of supplier interest in serving residential and other smaller-use customers, and frozen electric rates.

1. Transition Charges

The Customer Choice Act permits electric utilities to levy transition charges on customers that switch from bundled service to delivery services, either by taking power from a RES or purchasing power under the PPO. Only ComEd and AmerenIP now have tariffs in place permitting the imposition of transition charges. AmerenCIPS initially imposed transition charges, but suspended them with Commission approval starting in 2003.

The Customer Choice Act uses a "lost revenue" concept to derive the level of transition charges that utilities may impose. Under this approach, the calculation of transition charges permits utilities to recapture through the transition charge essentially all revenue lost when a customer purchases power from an alternative supplier or through the PPO, less a percentage of the customer's bill known as the "mitigation factor."

[23] Data is current as of October 2005.

The existence of the mitigation factor enables a customer of a utility imposing transition charges to anticipate savings by switching to delivery services because the mitigation factor is essentially a credit against applicable transition charges. The mitigation factor was initially set at 8% of the customer's base rate, has risen gradually since 1999, reached 11% in 2005, and will be set at 12% in 2006, the last year of the transition period.

Even though the formula used to calculate transition charges contains the mitigation factor element allowing customers to achieve savings, the existence of transition charges limits the amount of savings that customers can expect even when wholesale prices are low relative to the generation component implied in bundled rates. Transition charges are not fixed at a given level. Rather, there is an inverse relationship between wholesale market prices and transition charges – i.e., when wholesale market prices are relatively low, transition charges are relatively high, and vice versa. Hence, even when wholesale market prices are low, the savings that RESs could offer are reduced by the transition charge amount, leaving only the mitigation factor percentage as customer savings. And, when wholesale market prices that RESs must pay for their customer supply are high relative to the implied generation rate, the savings that RESs can offer customers are small and are further diminished by the transition charges.

Market values, and thus transition charges, are determined once a year in the ComEd service area. Whether retail competition grows often depends on changes in wholesale market values after the annual market value and transition charge calculation. Decreases in wholesale prices after the market values are set can make it easier for RESs to beat the bundled service price, while increases have the opposite effect. In the AmerenIP service area, market values are recalculated every two months, so market values closely track wholesale prices. Accordingly, savings for AmerenIP customers that switch to delivery services are still basically limited to the amount of the mitigation factor.

During the first few years of the customer choice era, the method of calculating transition charges resulted in significant annual variability in the level of transition charges and made customers wary of signing long-term contracts. In response to this problem, the Commission approved tariffs submitted by AmerenIP and ComEd that allow certain customers to "lock-in" a transition charge for a multi-year period.

After 2007, AmerenIP and ComEd will no longer be permitted to impose transition charges, which should give an immediate boost to competition. Potential savings for the customers in these service areas will no longer be reduced by the amount of the transition charge, and might give customers to whom the transition charge had applied a new incentive to consider switching to RES service.

2. PPO Service

Utilities that impose transition charges also have an obligation to offer an unbundled power and energy service called PPO service to non-residential customers that would pay a transition charge if they switched to alternative suppliers. Customers taking PPO service pay a generation charge priced at the market value, a delivery charge, an administrative fee, and a transition charge. The existence of the mitigation factor ensures that most (but not all) customers would pay a lower total electric bill than they would under the full bundled rate. Customers for whom transition charges are zero are ineligible for the service.

The PPO became an extremely popular alternative service offering in the three service areas in which it is offered (AmerenCIPS, AmerenIP and ComEd). In the AmerenIP service area, for example, the PPO was so popular relative to RES supply that, until 2005, less than 10% of AmerenIP's approximately 1,000 delivery services customers were purchasing their power and energy from a RES while over 90% of deliver services customers were on PPO service. In October 2005, more than twice as many delivery service customers in the ComEd service area were taking PPO service as were taking service from RESs.

Utility PPO service mimics a lower-cost supplier with direct access to the type of customers that are likely to consider switching from bundled service. Customers considering delivery services can expect to save about as much on their electric bills by signing up for the PPO service with the utility as they could by purchasing power from a RES.

From a long-run competitive point of view, it is preferable to have delivery services customers taking RES service rather than PPO service, since the PPO will only be offered in its present form until the end of the MTP. After 2007, PPO customers will likely have to switch to a RES if they wish to continue receiving savings compared to the bundled rate offered by utilities.

3. ARES Application Requirements

The applications of several prospective suppliers have either been denied or have been withdrawn during the certification process. The principal reason for these actions is the difficulty that applicants have had in meeting the "reciprocity" requirements of Sec. 16-115(d)(5). The reciprocity requirements have thus been a significant factor in limiting the number of suppliers, and likely, the growth of retail competition.

4. Lack of Supplier Interest in Serving Residential Customers

Even though residential customers have been eligible to switch suppliers since May 2002, it was only in 2005 that the first RES received certification to serve residential customers. The lack of interest among suppliers in serving residential customers was not entirely unexpected. Savings that residential customers can expect by switching suppliers are very low (probably less than $100 annually, given that savings are limited to the mitigation factor) while supplier transaction costs are relatively high. Residential bundled rates are fixed (rather than fluctuating monthly), and after the statutory rate cuts, are now closer to the national average. And, the reciprocity provisions may have discouraged or even prevented some suppliers who might wish to serve residential customers from entering the Illinois market.

Over 150,000 small-volume customers are now participating in natural gas customer choice programs in Illinois, so there obviously is interest among the State's smallest-use customers in considering the rates and services offered by non-utility energy suppliers.[24] However, perhaps for the reasons cited above, RESs have not presented alternative service offerings to residential electric customers.

5. Frozen Customer Rates

As noted above, non-residential customer rates were frozen at 1997 levels, and the rates for most residential customers were cut 20%. The frozen rates have presented a large obstacle to alternative suppliers in acquiring customers because they limit the amount of savings that a supplier may be able offer to customers. At various times throughout the MTP, RESs have been unable to offer any savings to some customers because the cost of acquiring power and energy at market prices was higher than the cost of generation embedded in bundled tariffs. After the MTP, the largest utilities will purchase power from the wholesale market and utility rates and the rates offered by RES will continue as now to be based on current wholesale market rates. Thus, RESs will no longer have to contend with any automatic price disadvantage relative to bundled utility rates, and RES rates should generally be competitive with utility rates.

V. Prospects for Retail Competition after 2006

Retail competition, as measured by the percentage of customers and customers load that has switched to either PPO service or RES service, has established a secure base only among the largest customers in the AmerenIP and ComEd service territories. The customer switching percentage for these customers is high (29% for AmerenIP and 70% for ComEd), and the percentage of customer load that has switched is over 50%. Switching rates drop considerably as customer size decreases. The customer switching rate is less than 2% for customers under 1 MW, except in the ComEd service area, where the delivery services switching rate is about 6%, and even in the ComEd service area, the RES switching rate is less than 2%.

While the Commission has attempted to encourage retail competition through the implementation of various policies, the main obstacles to RES success in acquiring customers – frozen rates, PPO service as a competing supply option and the imposition of transition charges in some service areas – cannot be changed without legislative action until the expiration of the MTP in January 2007. Whether these changes will be sufficient to bring about a higher degree of retail competition in the various service territories than currently exists or whether only a subset of customers will have a realistic opportunity to save money by switching suppliers are big unanswered questions.

---

[24] Illinois Commerce Commission, "Annual Report on the Development of Natural Gas Markets," July 2005, p. 7.

The Commission believes that there are reasons to be optimistic that additional non-residential customers in the larger service areas that have not yet taken advantage of the opportunities presented by customer choice will consider switching to RESs after 2006. The absence of transition charges and the lifting of the rate freeze should remove two obstacles that have hampered market development since the market opened in 1999. The Ameren companies' and ComEd's entrance into RTOs should enhance the competitiveness of the wholesale market. Additionally, utilities are no longer able to take action to entice customers to continue to take utility service by offering discounted rates, new products or other inducements.

On the other hand, if customers continue to have a choice of remaining with the utility at a reasonable rate that is based on purchases from the same market as the market from which RES purchase power, then competition may be limited to only a small set of customers. These customers will be those whose actual cost to serve is less than the utility's rate for their class.

As for smaller-use customers, given RESs' almost total lack of interest in the residential market up to this point, it seems unlikely that significant numbers of residential customers or customers in the smaller service areas will have an opportunity to choose an alternative supplier in the near future.

This section provides a brief view of the prospects for retail competition in the State's various service territories after 2007. How competition develops will likely depend to a great extent how utilities price power after 2007. The discussion below is general in nature as pricing and procurement issues are currently the subject of Commission proceedings.

A. AmerenCILCO, AmerenCIPS and AmerenIP

The customers that first switched to delivery services in the AmerenCILCO area switched in 2004, about five years into the customer choice era. As of November 2005, two customers, comprising about 28% of total customer usage over one MW, and eight smaller customers have switched to RESs. Only one RES is serving in the AmerenCILCO area. AmerenCILCO does not offer the PPO.

The reasons for these switching rates are probably due to a combination of very low rates compared to rates elsewhere in the State and AmerenCILCO's decision to sign hundreds of industrial customers to power contracts prior to the opening of the market in October 1999. These factors will no longer be barriers after 2007, however. AmerenCILCO's rates will undoubtedly increase in 2007, as they were last set in the early 1980s, and the contracts it signed with industrial customers have already expired or will expire in the near future.

Switching to delivery services in the AmerenCIPS service area has dwindled considerably over the past several years. In 2002, when AmerenCIPS still imposed transition charges and offered the PPO, about 750 customers were receiving delivery services, about two-thirds of which were PPO customers. However, in 2003, AmerenCIPS suspended its transition charges, which have not been reinstated, and most of the customers that were taking PPO service when transition charges were suspended have returned to bundled service rather than continuing on delivery services by purchasing from a RES. The number of RES customers has shrunk to around 100.

The low switching rates may simply be a reflection of the difficulty that RESs have in providing savings for customers during a period of rising wholesale prices. If that is so, the RESs might renew their interest in serving the AmerenCIPS area after 2007.

There are encouraging signs that retail competition is beginning to take hold in the AmerenIP service area. About 100 customers with a demand under one MW that were taking PPO service moved over to RES service in 2005, and the proportion of customer load over one MW that is taking delivery services in the AmerenIP service area is now over 50%. On the other hand, less than 1% of customers under one MW are taking delivery services. In 2007, if the PPO is no longer a useful and available supply option, the extent of delivery services in the AmerenIP service area may be largely limited to large customers, unless the expiration of transition charges and the rate freeze encourage RESs to move into the AmerenIP service area and market to smaller-use customers.

B. Commonwealth Edison

By almost any measure, there has been more competitive retail activity in the ComEd service area than in any other service area of the State. ComEd has more RESs operating in its service territory and more load and a higher proportion of both small and large customers have switched than elsewhere in the State. Almost three-fourth of large customers and more than one-third of the load of non-residential customers under one MW has switched.

However, improvements in retail competition are possible in the ComEd service area, especially among customers under one MW. A significant portion of delivery services customers and load is taking PPO service. While over 21,000 ComEd customers are taking delivery services, only about 6,300 customers are buying their power from RESs. Only 6% of smaller-use non-residential customers have switched to delivery services, and about two-thirds of those customers are taking PPO service.

In 2007, the elimination of transition charges and the possible increase in bundled rates should stimulate competition, and encourage present PPO customers to switch to RESs, particularly if the PPO is not a viable supply option for non-residential customers.

C. Interstate Power, MidAmerican Energy, Mt. Carmel, and South Beloit

There has been almost a total lack of interest in delivery services among suppliers in serving in the State's smallest service areas, even though none of the utilities charge transition charges. The end of the MTP is not likely to increase the prospects for competition in the three smallest service areas. However, supplier interest in the MidAmerican service area might increase after the MTP if Commission approves any adjustment to MidAmerican's bundled rates.

D. Residential Customers

One supplier is now certified to offer service to residential customers. Hopefully, others will join the market in 2006, or after the end of the MTP, when customer rates may rise above current levels. Even if rates were to rise, however, given the reality of customer acquisition costs, large-scale residential customer migration to delivery services seems unlikely in the near future.

VI. Recommendations

This section lists legislative recommendations that the Commission believes would address some of the impediments to wholesale and retail competition identified in the previous sections. The implementation of these recommendations would likely require action by the General Assembly.

Recommendation 1. Enhance the Commission's Wholesale Market Monitoring Capability

(1) Modify Section 7(1) of the Freedom of Information Act to include an exemption for information from the RTOs.

<u>"Information and data submitted to the Illinois Commerce Commission by a regional transmission organization concerning market participants' market and transmission system data that will enable the Commission to perform market monitoring functions."</u>

(2) Modify Section 16-126(i) of the Act, to insert the underlined language, as follows:

(i) The Illinois independent system operator created under this Section, and any other independent system operator authorized by the Federal Energy Regulatory Commission to provide transmission services as a public utility under the Federal Power Act within the State of Illinois, shall be deemed to be a public utility for purposes of Section <u>5-101, 5-105</u>, 8-503 and 8-509 of this Act.

(3) Modify Section 5-101 of the Act, to insert the underlined language, as follows:

Every public utility <u>and every entity owning a generator in Illinois that participates in markets operated by the independent system operator described in Section 16-126 of this Act</u> shall furnish to the Commission all information required by it to carry into effect the provisions of this Act, and shall make specific answers to all questions submitted by the Commission.

Discussion: Modification (1) would enable the ICC to keep the information that it receives from the RTOs confidential under FOIA. Modification (2) would enable the ICC to access information in the possession of the Midwest ISO and PJM. Modification (3) would enable the ICC to access information in the possession of Illinois generating companies that participate in markets operated by PJM and the Midwest ISO. Information from those entities is necessary for the ICC to perform market monitoring activities to ensure that a competitive wholesale and retail market will benefit all Illinois citizens, as required by Section 16-101A(d) of the Act.

Recommendation 2. Allow New Transmission Investments on the Basis of the Promotion of Competition

(1) Modify Section 8-406(b), to insert the underlined language, as follows:

> (b) ... The Commission shall determine that proposed construction will promote the public convenience and necessity only if the utility demonstrates: (1) that the proposed construction is necessary to provide adequate, reliable, <u>effectively competitive</u> and efficient service to its customers and is the least-cost means of satisfying the service needs of its customers;...

(2) Modify Section 8-503, to insert the underlined language, as follows:

> ...Whenever the Commission, after a hearing, shall find that additions, extensions, repairs or improvements to, or changes in, the existing plant, equipment, apparatus, facilities or other physical property of any public utility or of any 2 or more public utilities are necessary and ought reasonably to be made or that a new structure or structures is or are necessary and should be erected, to promote the security or convenience of its employees or the public, <u>or promote the development of an effectively competitive electricity market,</u> or in any other way to secure adequate service or facilities, the Commission shall make and serve an order authorizing or directing that such additions, extensions, repairs, improvements or changes be made, or such structure or structures be erected at the location, in the manner and within the time specified in said order;...

Discussion: In order to promote pro-competitive transmission upgrades and projects, whether they are proposed by RTOs or utilities, Sec. 8-406 of the Act should be modified to allow a certificate to be granted where such transmission upgrade or project can be shown to promote competition in the wholesale market. As it now stands, Sec. 8-406 of the Act requires public utilities to obtain a certificate from the Commission before commencing construction of transmission facilities. Sec. 8-406 states that the Commission shall issue such a certificate only if the facility will "promote the public convenience and necessity." While the Section goes on to state the factors that must be found by the Commission to support such a finding, the promotion of competition is not currently among those factors despite the fact that Sec. 16-101A of the Act directs the Commission to promote a competitive power market.

Recommendation 3. Clarify Commission Authority to Set Non-discriminatory Stand-by Rates

Discussion: Distributed generation typically refers to generation that is connected to or injected into the distribution level of the electric transmission and distribution grids on either the customer side or utility side of the meter or elsewhere on the distribution grid. Distributed generation includes combined heat and power applications, fuel cells, natural gas micro-turbines, wind turbines, landfill gas recovery systems, photovoltaic cells and other small generating units.

Distributed generation can potentially contribute to the development of a competitive marketplace for electricity in Illinois by reducing peak system demand, providing demand flexibility for customers, increasing system reliability and providing a competitive check on retail electricity markets. Distributed generation interconnection applications, procedures, studies and fees are not specifically addressed in Illinois administrative codes or legislation. Currently, there is a rather disjointed patchwork of interconnection procedures, stand-by or backup charges, and study fees that often discourage customers from considering distributed generation as a substitute or complement to traditional electric supply. The Commission should be given the authority to investigate and set fees and rates for each electric utility to ensure that interconnection study fees and standby rates do not discourage customers from considering the implementation of distributed generation, if that does not already exist under the Act.

Recommendation 4. Eliminate or Modify the 24-month Minimum Enrollment Requirement in Sec. 16-103(d)

Discussion: The minimum enrollment provision, applicable to customers consuming less than 15,000 kWh annually but not to larger-use customers, is inconsistent with customer choice principles. Customers should not be tied to either utility or RES service, but rather should have the right to choose the service provider that bests suits their circumstances.

An alternative to this recommendation would be to modify Sec. 16-103(d) to reduce the potential term on bundled service to 12 months only.